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RHEFDIA/DIA WASHINGTON DC PRIORITY
RUEATRS/DEPT OF TREASURY WASHINGTON DC PRIORITY
RUEKJCS/Joint STAFF WASHINGTON DC PRIORITY
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C O N F I D E N T I A L SECTION 01 OF 02 ISLAMABAD 001270

SIPDIS

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SUBJECT: CONCERN GROWS OVER TAX POLICY/ADMINISTRATION
BACKSLIDING

REF: ISLAMABAD 1137

Classified By: Acting Deputy Chief of Mission Elizabeth Richard for reasons 1.(b) and (d)

¶1. (C) Summary: Discussions with GOP officials and the IMF ResRep indicate little progress in both tax policy and tax administration reforms, cornerstones of the Fund's Standby Arrangement, in spite of high-level GOP commitments to make improving tax policy and collection a top priority (reftel). Customs officials have filed a stay order in a Lahore court to prevent the merging of the customs and sales tax departments of the Federal Board of Revenue (FBR), a key part of the on-going World Bank funded income tax reform program. Customs officials have also reportedly refused to sign on to a new automation system, and a World Bank advisor told us that the GOP is trying to walk away from the whole automation process, as the accountability it will provide runs counter to entrenched interests. Tax receipts have actually declined in recent months, as customs officials have carried out impromptu work stoppages, and the GOP will fall short of its IMF revenue target. The new chairman of the Federal Reserve Board reports that the GOP will miss current revenue targets by \$750 million; he appears to have no vision for tax policy reform to match Finance Advisor Tarin's, and his tax collection targets for FY 2009-10 are extremely modest. Ministry of Finance officials tell us that the agricultural sector will not be taxed for at least two years, again despite Tarin's promises to the contrary. These signs indicate that, after an excellent start of meeting IMF program requirements, the GOP will be unable to implement those reforms that actually impinge on various entrenched interests. End Summary

¶2. (C) IMF Resident Representative Paul Ross (protect) told us May 29 that he was quite concerned about the GOP's backsliding on both tax administration and tax policy issues (he was less concerned by the inclusion of the agricultural sector in the tax net, which has been under debate for decades and will not be resolved overnight). This backsliding was exemplified by a recent court case filed on behalf of customs officials asking for a stay of the merger of the customs and income tax departments of the Federal Board of Revenue, one of the key reforms that the GOP is implementing under their five year tax reform program with the World Bank. According to a World Bank advisor, the merging of the two departments was done in lieu of revamping the entire Income Tax Act, which was considered too ambitious to tackle; the Bank did write an entire new act for the Pakistan Revenue Service in 1998, but it was never passed.

This lawsuit puts the administratively mandated merger into jeopardy, as it leaves passing legislation, which could take years, as the only clear way forward.

¶3. (C) We were told by Yasmin Yusuf Khan, deputy commissioner, income tax, (protect) that the driving force behind this lawsuit was Athar Manallah, a former Customs official (who had reportedly been fired) and confidant of Chief Justice Iftikhar Chaudhary. It is apparently not permitted for civil servants to file court cases against their government supervisors, so there appears to be no legal basis for this action. Khan, who had just finished a stint in the U.K. studying their tax system, told us that these departments are merged in almost all tax systems, as it eliminates duplication of audits and chances for corruption. Khan said that, although the two divisions in the FBR had been nominally merged under one Director General, reporting lines remained separate and there was no sharing of data. Khan said that customs officials were offered double their salary to sign on to the new automated customs systems, which are being installed in Lahore and Port Qasim, but most have refused (the implication being that even double salary is not sufficient to compensate for foregone bribes.) The World Bank advisor noted that they were trying to stop the entire automation, because this would bring in accountability. He said that 3,000 clearing agents were among the most corrupt and powerful forces in Pakistan, and the new direct trade declaration system would render their services obsolete.

¶4. (C) Econoffs met with the newly appointed head of the Federal Bureau of Revenue Sohail Ahmed on May 28. He said he

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expected the GOP to miss its current IMF revenue target of \$15.75 billion by at least \$750 million. His revenue targets for the coming fiscal year were extremely modest - only \$2 billion over last year's target, much of which would be accomplished by inflation, and only \$375-500 million additional through better enforcement. Ahmed said the main tax policy in the next budget would be not to overburden the manufacturing sector, which pays a disproportionate share of taxes. He did not expect any new tax initiatives in the coming fiscal year, noting that every initiative must be approved by Parliament and that improvements would come by removing "small anomalies" in the system. He said that the FBR planned to go to the provincial governments to request that they allow the federal government to collect taxes on services in the provinces, in exchange for 15 percent of the receipts. He acknowledged, however, that Sindh and Punjab, in particular, would be extremely unlikely to approve this request. Ahmed said that rumors of taxing stocks and real estate were baseless. Ministry of Finance officials in charge of preparing the budget said that the agricultural sector would not be taxed for at least two years, as they "needed time to get used to the idea."

¶5. (C) Comment: The average tax-to-GDP ratio in South Asia is 14 percent. Pakistan has struggled unsuccessfully to break the 10 percent barrier for years. Without a solid tax base to support development expenditures and to provide basic services to the average Pakistani, the government will continue to struggle to gain legitimacy and will remain dependent on foreign assistance. It is worrisome, to say the least, that after nearly five years, tax reforms have gained so little traction, and that the Finance Advisor is unable to implement his vision of a broader tax net and a more efficient collection apparatus.

PATTERSON